

## **Discussion Paper: Honoring Pre-Existing Rights in the RTO Environment**

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The purpose of this Discussion Paper is to lay out the rationale for requiring that the recipients of RTO transmission rights participate in the RTO's FTR auctions.

### **1. Background**

Entities that are entitled to use flowpaths, whether under Pre-Existing Contracts or by otherwise paying for the sunk costs of the Grid (whether through contributions to the Annual Transmission Revenue Requirements of the RTO Grid or through payment of wheeling fees) are entitled to the use of appropriate shares of the RTO's flowpaths. The entities' entitlements can be honored by allocating to the entities either: (i) rights to use the flowpaths (FTRs) or (ii) sufficient funds to enable the entities to purchase the identical quantities of such FTRs in the RTO's auctions.<sup>1</sup>

There are many reasons why it is preferable that the RTO allocate FTR auction revenues, rather than FTRs, to the holders of existing rights to use the RTO Grid. These include economic efficiency, mitigation of market power, the creation of liquid markets for transmission access, practicality, and the creation of a flexible mechanism to deal with the honoring and conversion of existing rights. These reasons are briefly described in the Appendix to this Discussion Paper.

However, the most-compelling reason for the allocation of FTR auction revenues rather than allocation of FTRs is that without such an allocation mechanism (or a mechanism that is reasonably similar), there will be little reason for creating an RTO. In fact, under the FTR allocation approach, Eligible Customers would be substantially worse off under the RTO than they would be under Order 888 Open Access Tariffs. This is particularly true in light of the discussions that have taken place over the past few weeks regarding the allocation of Pre-Existing Rights.

### **2. Allocation of Pre-Existing Rights: Status of Discussions**

In the course of the pre-existing rights discussions, parties have made claims to virtually all of the RTO Grid's transfer capability. Parties have laid claim not only to the FTRs that would be used to provide existing transmission service, but they also claim: (i) rights that would allow them to take service independently of other transmission customers (using up more ATC because of the loss of diversity associated with the non-coincident peak demands of the customers), (ii) "rollover rights" to continue service after contracts have expired (or indefinitely, in the case of so-called "Load Service Obligations"), (iii) rights to ATC to meet load growth (even where such purported rights are not clearly stated in any contracts), (iv) rights to continue to sign new agreements until the RTO's Operation Date. Cumulatively, these claims would consume virtually all of the

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<sup>1</sup> The FTR auctions are proposed to be market-clearing price auctions in which all winning bidders for FTRs on a flowpath pay the "market clearing price" (MCP) for the FTR. In this type of auction - which is conducted separately for each flowpath - parties bid for the FTRs, the RTO stacks the bids from highest to lowest, allocates the FTRs to the highest bidders and works down the stack of bids until the RTO has exhausted its supply of FTRs. The last accepted bid sets the MCP and this price is charged to all of the winning bidders. Thus, if an entity knows that it will receive a revenue entitlement equal to the MCP of an FTR, then the entity can specify an unlimited bid for the FTR; and whatever the MCP is, the entity will receive sufficient revenue to acquire the FTR. No entity that does not receive an allocation of FTR auction revenues could conceivably outbid the entity that does have such an entitlement.

commercially-valuable FTR rights on the RTO Grid, leaving nothing of any value for other grid users.

### **3. Discussion**

The translation and conversion of existing rights from the pre-RTO transmission access paradigm to a system which meets the requirements of Order 2000 is not an easy task due to all of the conflicting and unsubstantiated claims that many parties have made. Flexibility on the part of all parties is required if the process is to meet the “no losers” test.

The current proposals to allocate virtually all grid usage rights to existing customers do not meet the “no losers” test with regard to parties that do not have existing rights. Under Order 888, Eligible Customers can request transmission service and must be provided that service if provision of such service would not compromise reliability and would not result in increased costs or a loss of service to existing grid users. Under Order 888, an Eligible Customer could request the use of a fully-subscribed transmission path and the transmission provider would be required to make service available to that Eligible Customer as long as it was physically feasible to do so. The transmission provider might have to exercise redispatch of its resources (in essence, backing down its own use of the path), and in such a case (under *Penelec* and subsequent FERC decisions) the Eligible Customer would pay the higher of the embedded cost-based transmission rate or the redispatch cost. I.e., the new customer would not be precluded from using the congested flowpaths, and the new customer’s rate would - nine times out of ten - be no higher than the rates of the existing grid users. And in the rare case in which redispatch costs were higher than the embedded cost-based transmission rate, the new customer would nonetheless be permitted to use the congested flowpath.

The rationale under Order 888 is simple. The new customer does no harm to the existing grid users. It either makes some contribution beyond the margin, or in rare cases makes no contribution but does not cause any cost increases. And the resulting bottom line is that under Order 888, new transmission uses have rights to the use of the grid, and those rights are generally on par with the rights of existing users.

To date, the RTO’s pre-existing rights discussions have ignored these rights of non-incumbents. And through the positions advocated in the August 21, 2000 Pre-Existing Rights strawman, the rights of non-incumbents (as well as the rights of incumbents to new uses of the RTO Grid) would be completely eliminated. Under the existing proposals for load growth, rollover rights, grandfathering, and allocation of FTRs rather than revenues, the entire grid would be allocated to existing uses and - short of paying for system expansion - new users would have no rights whatsoever. The new uses would also be at the mercy of incumbents who, having been allocated FTRs rather than FTR auction revenues, would have no obligation to make rights available (when under Order 888, those same incumbents are required to make rights available both through ATC and through redispatch). The current Pre-Existing Rights proposals simply do not pass the laugh test, let alone the “no losers” test.

### **4. A Proposal**

Under the RTO regime, virtually every party will need to do business differently than it does today. There is no way to move to the new world - in which transmission congestion is managed efficiently and price signals are sent for efficient short-term uses of the grid and long-term expansion of the grid - without major changes.

The non-incumbent group<sup>2</sup> makes the following Proposal as a means of meeting the RTO's objectives while meeting the "no losers" test :

Provided that:

1. The RTO transmission pricing proposal retains those elements of Pricing Option #6 which guarantee that no grid export charges will be levied; and
2. The entities who would be allocated transmission rights under the proposals in the Pre-Existing Rights strawman would either be allocated FTR auction revenues or be required to place their FTRs into the RTO's auctions (consistent with the alternatives outlined below)

the Pre-Existing Rights strawman's proposals for: (i) allocation of transmission rights to PECs and LSOs, (ii) load growth, and (iii) rollover rights would be considered fair and supportable.

## **5. Discussion**

Under the Proposal, virtually the entire capability of the existing grid would be allocated to the entities that pay for the embedded costs of the transmission grid (whether by contract or by direct payments to the Annual Transmission Revenue Requirements of the PTOs). This can only be considered reasonable in a pricing framework in which other grid users do not make contributions to the payment of the embedded costs of the grid<sup>3</sup> - hence the important linkage to Pricing Option #6. On the other hand, if grid users do pay for the embedded costs of the grid through export fees, then those entities must be entitled to allocations of FTRs on par with all other grid users.

Similarly, the requirement that entities who are allocated FTRs participate in the FTR auctions mitigates against the grid access that non-incumbents would otherwise lose under the Pre-Existing Rights strawman. This mechanism would help to ensure that future grid users do not lose the grid access that they currently have under Order 888. (And as discussed in footnote 1 and later in this Discussion Paper, the parties who are allocated FTRs would be exposed to absolutely no risk that they will lose the FTRs that they need to serve their own loads.)

If a majority of parties can agree to the Proposal presented above, we may have achieved a breakthrough in the management and conversion of pre-existing rights. Conversely, absent the two conditions above, it is inconceivable that the Pre-Existing Rights strawman would remotely preserve the current rights of grid users under the FPA or Order 888. The strawman would result in inherently non-comparable service, and as such would be fatally flawed.

## **6. Options for Making FTRs Available to the Marketplace**

<sup>2</sup> Note: the proposal presented in this Discussion Paper has, of course, not been approved by every non-incumbent and is being presented for the first time this week. Clearly, not every party in the non-incumbent coalition, not to mention those who are not participating in the coalition, has had time to digest this proposal, and some may disagree with it.

<sup>3</sup> Note that those who use the grid for exports would still be required to acquire FTRs to use flowpaths, including export flowpaths, so they would be paying the marginal value of their usage of the grid and thereby making some contributions to the Grid's embedded costs. Under the Proposal, these contributions would not create entitlements to allocations of FTRs or FTR auction revenues.

“Alternative 2” in the Pre-Existing Rights strawman:

The preferred method for allocating the existing rights to use the grid is for the RTO to allocate to transmission customers the auction revenues associated with those FTRs to which RTO deems the customer to be entitled. This approach meets the comparability and efficiency requirements of Order 2000. It passes the “no losers” test. And it provides all of the other benefits outlined in the Appendix to this Discussion Paper.

“Alternative 3A” in the Pre-Existing Rights strawman:

Under this alternative, smaller transmission customers would be exempted from mandatory participation in the FTR auctions. (The criteria for determining “small” are flexible. At this time, “small” is roughly defined as receiving an entitlement of less than 10% of the FTRs on a flowpath. Other criteria which would achieve the same objective - exempting small entities who need FTRs for the purposes of *feasibility* of serving load - can also be considered.)

Customers who receive larger amounts of FTRs would be required to participate in the FTR auction. But even those customers could guarantee that they would not be forced to relinquish any FTRs by specifying a “reserve price” below which the FTRs would not be released. In addition, the auction would be structured to ensure that the FTR entitlees (and only FTR entitlees) could specify the RTO’s default maximum price and so, never be outbid.<sup>4</sup>

Although exempting smaller transmission customers from the auction would result in greater inefficiencies than Alternative 2, it is proposed as a mechanism to ease the concerns of smaller customers who fear participation in the auction. The “reserve price” mechanisms also means that - for both small and large grid users - no cash would be required to change hands and no tax liabilities would be triggered.

“Alternative 3B” in the Pre-Existing Rights strawman:

This alternative is similar to Alternative 3A in that it would exempt smaller customers from mandatory participation in the FTR auctions. Alternative 3B has the added benefit (compared to Alternative 3A) of mitigating the market power of larger grid users who might choose to place unreasonably-high prices on their FTR allocations. This mitigation is accomplished by requiring that those customers also be willing to purchase additional FTRs at a price that is reasonably close to the price at which they are willing to sell FTRs.

Although Alternative 2 is superior to Alternatives 3B and 3A, and Alternative 3B is superior to Alternative 3A, various parties have expressed willingness to consider any of these three Alternatives as part of a compromise package. On the other hand, Alternative 1 in the Pre-Existing Rights strawman (i.e., allocation of FTRs with no obligations to participate in the FTR auctions) and Alternative 4 (which is virtually identical in its effects to Alternative 1 and in addition would arguably compromise federal jurisdiction over transmission access) would achieve none of the comparability, reasonability or efficiency goals outlined in this Discussion Paper. They provide no basis under which non-incumbents can preserve the transmission access rights that they have today.

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<sup>4</sup> As noted earlier, this is a “belt, suspenders and three pairs of pants” approach because it is inconceivable that any non-FTR entitlee could ever afford to bid such a high price.

## Appendix

Summary of reasons why monetization of FTRs through the allocation of FTR auction revenues to grid users is superior to the allocation of FTRs:

### 1. Preservation of the Transmission Access Rights of All Eligible Customers

As described in the body of the Discussion Paper, allocation of FTRs to incumbent users of the grid would grant them rights that are superior to the rights that they have today, at the expense of entities who could today rely on ATC and on redispatch by the transmission owner in order to obtain transmission access.

### 2. Mitigation of market power

It would be much easier for the large utilities' retail merchants to use their market power anti-competitively if they could exercise that market power passively (by sitting on their pre-allocated FTRs), compared to having to exercise that market power actively by specifying bids for FTRs in the RTO's auctions. Conversely, it would be much easier for the RTO's market surveillance staff to detect and expose anti-competitive behavior by review of the prices that are bid for FTRs - especially if those prices bore no rational resemblance to what an entity would bid if the entity did not have market power.

### 3. Economic Efficiency

Providing entities with auction revenues will incite the entities to make conscious decisions about the economic value of the FTRs that they choose to acquire. This will result in much more efficient use of the transmission grid and in *conscious* tradeoffs between use of congested wires vs. purchases of energy/capacity vs. implementation of dispatchable demand programs vs. acquisition of distributed generation.

Conversely, if FTR auction revenues are not allocated, it would be all too easy - because there will be no need for explicit, visible decision-making - for load-serving entities to make decisions that are bad for their customers (simply to favor the use of the load-serving entity's own resources), to avoid making economically-rational tradeoffs (because of risk aversion, fear of regulatory scrutiny or other reasons), and to discriminate against competitive alternatives to the use of the load-serving entity's resources and/or wires.

### 4. Creation of liquid markets for FTRs

If all FTRs must be acquired at auction (rather than pre-allocating 90%+ of the grid to the utilities' retail merchants), there will be far more activity in the primary and secondary markets, deeper and more-liquid markets, and more meaningful spot prices for FTRs.

Conversely, if FTR auction revenues are not allocated, many of the utilities' retail merchants would - as outlined earlier - stay out of the marketplace for reasons ranging from fear of regulatory scrutiny to the desire to implement anti-competitive strategies. Withdrawing 90%+ of the FTRs from the marketplace would also make the FTR market much more subject to volatility, price spikes and manipulation due to restricted supply.

### 5. Flexibility

Under many contracts, entities may not be entitled to the equivalent of a MW of firm transmission service year-round, but instead to transmission service that is conditional depending on the

proposed schedules of other network subscribers. On the other hand, under some contracts, entities are entitled to flexible transmission service that can not be easily translated to the FTRs associated with a single feasible dispatch. Just as each member of a group of 8 individuals who were collectively sharing the use of 5 automobiles could not each be allocated an automobile when the group disbands, individual transmission customers cannot be allocated FTRs which will satisfy the needs that were met collectively.

Allocating money rather than FTRs to the transmission customers allows them to negotiate with one another to allocate the FTRs to the highest valued uses (similar to selling the 5 automobiles to a trust, allocating the proceeds to the 8 individuals, and allowing the individuals to rent the automobiles from the trust).

## 6. Practicality

In virtually every field of commerce, people conduct business by using money, not by trading bushels of corn for barrels of milk, or reels of copper for ingots of gold. Trade is facilitated by using money as a medium; trade and efficiency are harmed where there is no common currency.

With many grid customers entitled to a share of the scarcity value of the grid (and many, many more customers entitled to their shares as every region opens up to retail access) it would be impractical to allocate to each customer that customer's share of FTRs. It is far more practical and manageable to allocate a pro rata (or other) share of auction revenues to customers, rather than to allocate 0.0004386 of an FTR to customer i, 4.286 FTRs to customer j, etc.

## 7. Breaking the logjam in the conversion of pre-RTO rights to RTO rights

There is no possible way to convert the complete set of existing contracts and grid uses, with all of their flexibilities, into allocations of FTRs that will guarantee the identical capabilities to each potential PTO. The controversies surrounding "rollover rights" and "load growth" compound the problem. The Pre-Existing Rights strawman tries to grapple with these issues by giving away virtually all ATC to claimants of existing rights. Putting aside the matter of the obvious discrimination against new uses of the RTO Grid, it remains unlikely that even this give-away will solve the problem for all grid users.

This intractable problem stems from the mindset of many existing grid users of focusing on transmission rights rather than the total package of benefits associated with participation in the RTO. This problem is probably the single most-significant threat to the formation of the RTO.

A solution to this problem lies with potential RTO participants thinking instead in terms of the "total value" created by their participation in the RTO. Monetizing FTRs and allocating to participants the revenues rather than the rights will facilitate broader thinking about the total value gained by participating in the RTO. It will create more possibilities for keeping parties whole because each party does not have to be kept whole on each particular flowpath, but only in the aggregate (and also considering other cost shifts and cost savings associated with transfer payments, etc.). Monetizing FTRs also holds the potential for breaking the logjam associated with suspension of the existing contracts of the PTOs.